GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Tennessee, Florida, North Carolina, Texas, Wisconsin, Minnesota, and Colorado!

A PERSONAL NOTE

This *Musings* should hit your email inbox on New Year's Eve, demonstrating, if nothing else, that *Musings* never sleeps. We wanted to take this opportunity to thank all of our community bank clients - many of whom have become good personal friends and friends of the firm - for your business, support, and friendship this past year and over many years. All the professionals and staff at Gerrish Smith Tuck, Consultants and Attorneys appreciate what community banks do for their communities and our nation, and we are grateful for our relationships with and ability to assist community banks in reaching their objectives.

BANK CAPITAL

As regular *Musings* readers will note, we often meet with community bank boards to discuss capital issues. In fact, we have had a number of banks looking to increase capital due to asset growth or to take advantage of other opportunities. Our general advice is to use your community bank holding company as it was designed (i.e., the first consideration is the possibility of leveraging the bank holding company, generating cash through the incurrence of debt at the holding company, and downstreaming that cash to the bank to increase the leverage ratio).

To ensure compliance with the requirements imposed by the U.S. Internal Revenue Service, we inform you that any tax advice contained in this communication (including any attachments) was not intended or written to be used, and cannot be used, by any taxpayer for the purpose of (1) avoiding tax-related penalties under the U.S. Internal Revenue Code or (2) promoting, marketing or recommending to another party any transaction or tax-related matters addressed herein.

A number of our clients do that on a regular basis to maintain what the board deems to be an appropriate leverage ratio at the bank level. (For most that are looking to support the bank leverage ratio with holding company debt, the leverage ratio of choice is somewhat on the lower end of the spectrum at 8.5% or 9%.)

We recently had an inquiry from a community banker about the possibility of using the holding company line of credit for a few days before the end of each quarter to borrow some money at the holding company, generate cash, and downstream the cash into the bank, thereby increasing the bank's leverage ratio so that at the end of the quarter the Call Report reflects a leverage ratio desired by the board. The plan would then be to dividend the money out of the bank immediately after the end of the quarter and repay the holding company debt. This particular bank wanted our thoughts on this proposed plan.

Our not-so-subtle response was "Don't do that!" It's not that the activity (i.e., leveraging the holding company on a short-term basis) would not have the appropriate impact on the bank's leverage ratio (i.e., it would raise it for purposes of reflecting a higher leverage ratio on the Call Report). The bigger problem is, based on our experience with a couple of banks who have actually done this (without consulting us first), is the regulators will take the view that this activity by the bank and its holding company are causing the bank to provide financial statements reflecting an artificially inflated leverage ratio. In other words, the financial statements provided by the Call Report are not accurate. This in and of itself is a significant problem with the bank regulators.

Our simple advice is, if your community bank holding company is going to use leverage to put capital in the bank, do so as appropriate, but leave it in there, at least for some period of time, until it is appropriate to term out the holding company debt or something else occurs at the bank level (such as asset shrinkage) that would no longer make that injection of capital necessary.

As noted, our first step on the "how do we raise capital for our community bank" tour is to leverage the holding company. Do it legitimately, however, not simply to inflate the bank's leverage ratio on a temporary basis.

A UNIQUE TRANSACTION

Multi-bank holding companies are not terribly uncommon in community banking. It is possible for a bank holding company to own multiple subsidiary banks that are separately chartered institutions. Typically, the issue with a multi-bank holding company is that if there is any

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transaction at the bank level, the most common scenario is to merge the subsidiary banks together to put two or more charters into one surviving charter. However, that is not always the case.

Rather than merging the subsidiary banks together, it is possible to split the multi-bank holding company into separate one-bank holding companies. If that is done, a new holding company is created as a subsidiary of the existing holding company, the bank stock of one of the banks is contributed to that new company, which makes it a mid-tier bank holding company, and then the common stock representing ownership of the mid-tier holding company is "spun out" to the existing shareholders. This leaves the holding company shareholders owning two one-bank holding companies, rather than one bank holding company that owns two subsidiary banks.

This type of transaction is not common, but it certainly serves its purpose. It certainly makes sense if the strategic plan for the two banks is different to the point that having common ownership under one holding company impedes rather than promotes achievement of the strategic objectives. If that is the case, we think it is best to seriously consider a "disassociation" transaction to separate the two banks into one-bank holding companies, rather than maintaining the two-bank holding company structure.

CASH-OUT MERGER TRANSACTIONS

We have assisted a number of community bank clients through cash-out merger transactions. If you are not familiar, this type of transaction converts certain of the holding company's shares to cash and keeps all of the other shares that are not converted to cash as holding company shares outstanding. Cash-out merger transactions are most often utilized when a C corporation converts to an S corporation. However, that is not the only time they are used. A number of times previously we have used cash-out mergers to put excess capital to work by executing on a strategy of "ownership restructuring" and forcing the redemption of certain of the holding company shares.

One of the questions that often arises in a cash-out merger transaction is the basis of discrimination as it relates to the shares. Simply put, the question is on what basis can certain shares be required to accept cash and others remain as holding company shares outstanding? The answer is generally any basis that has a "valid business purpose" and does not illegally discriminate on a prohibited basis, such as based on age, sex, race, gender, and the like.

The most common form of basis for cash-out merger transactions is the number of shares owned. In this type of transaction, if a holding company shareholder owns less than a specified

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number of shares, their shares are converted into the right to receive cash. We have also seen these types of mergers discriminate based on the shareholder's state of residence (e.g. out-of-state shareholders are cashed out), the shareholder's business relationship with the bank (e.g. shareholders that have no deposit or loan relationship with the bank are converted to cash), or the shareholder's failure to participate in the annual meeting (e.g. the shareholder has not returned a proxy or otherwise voted at any of the three most recent annual meetings).

Cash-out merger transactions for purposes of ownership restructuring are an appropriate corporate transaction to put excess capital to work by forcing a conversion of certain of the shares into the right to receive cash. If your holding company is going to engage in a cashout merger transaction, make sure the basis on which the holding company discriminates is not a prohibited basis and has a valid business purpose.

TRANSACTION DUE DILIGENCE

We recently had a discussion with one of our clients regarding transaction due diligence. In this particular transaction, we are representing a community bank that is buying a, comparatively speaking, much smaller community bank. We have executed the Indication of Interest and are now in the due diligence phase of the transaction.

Our client is taking primary responsibility for the completion of loan due diligence. This is generally considered to be an M&A best practice because it allows the acquirer to fully understand the target's credit culture and how that culture will combine with the acquirer's lending practices. During our discussion on the loan due diligence, our client's President indicated there were a couple loans that they saw that gave them somewhat of a pause on a preliminary basis. These were not really bad loans, but they were loans that the acquirer said they likely would not have made themselves. For that reason, they are looking further into those.

We are not quite at this stage yet, but it could be that these loans need to be addressed as part of the transaction. If the acquirer is not willing to take on the loans, it should not tank the deal. There are available options to address these types of issues.

The options on how to address these types of issues are really only limited by the creativity of the parties. Generally speaking, the most common treatment for this type of issue in a transaction is an escrow, earnout, or holdback. These are all generally the same thing and allocate some portion of the purchase price to the side for a set period of time. For example, $1 million of the purchase price could be set aside for 36 months. If the loans perform as agreed for 36 months, that money

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is then distributed to the selling shareholders. If the loans do not perform, the money is utilized to reimburse the acquirer for any loss associated with the loan. We have also resolved these types of issues by requiring certain loans to be taken out of the target bank prior to closing or by providing the loan to the selling shareholders as transaction consideration rather than cash.

As noted, there are a number of different ways these types of issues can be handled. If loan due diligence reveals some concern, it certainly does not mean the end of the line for the transaction.

LONG-TERM THINKING

Although most community banks do some type of long-term strategic planning, we generally encourage our community bank clients to set aside some time toward the end of the year to contemplate long-term issues that may need to be faced in the coming year or years. Many of the discussions we have with boards in this regard focus on specific issues, as opposed to general long-term planning for the organization. One of the main topics, as noted in the article above, typically is capital.

As community bankers fully understand, community banks must operate with certain minimum levels of capital to satisfy the regulators. The real issue with capital, however, is what does the future hold, and what does the bank need as it relates to capital? Is there a known need that the bank can currently identify as it relates to capital (i.e., anticipated significant asset growth, an acquisition of a bank, an acquisition of a branch, or another line of business)? Is there an unknown but anticipated need for capital for the future such as the death of a large shareholder or the buyout of a disgruntled shareholders? Is there something similar?

As we contemplate year-end and focus on the need for capital, the long-term thinking also needs to include how best the holding company or bank obtains that capital. As we have often noted in *Musings* (including this issue), generally our first choice recommendation to our clients is to use the community bank holding company for what it is designed for (i.e., to leverage capital into the bank). Capital needs of the community bank may extend beyond the ability to leverage the holding company, however. That generally requires the community bank holding company board to contemplate whether some type of stock offering, limited or otherwise, may be appropriate.

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The third part of the capital issue is how does the bank and holding company specifically allocate the capital and what is the timing? Use the end of the year to at least get together and contemplate/ruminate about some of these specific issues.

OUR PREDICTIONS FOR 2025

Given this is the final *Musings* of 2024, it seems appropriate that we provide the proverbial "looking forward" to the next year predictions. In order to fulfill this anticipated opportunity, we thought it appropriate to give a brief summary of what we anticipate community banking will experience in 2025.

In our view, 2025 will not be significantly different from a big picture standpoint than 2024. Many of the hallmarks of 2024 will carry over to 2025. In 2025, we believe the regulators will continue to force community banks to keep a close watch on liquidity. Community banks will also continue to have to make tough decisions on the allocation of capital.

We also anticipate 2025 will see a rise in overall profitability for most community banks when compared to 2024, which will give banks some relief as it relates to the challenge of balancing retained earnings growth, shareholder dividends or distributions, and other demands on capital. We also anticipate banks will see higher overall loan demand in 2025.

Overall, we do not see any hard right or hard left turns over the next 12 months and any significant differences from 2024. We believe M&A will still be challenging, and many of the challenges that were created by the Fed's unprecedented rise in interest rates will continue. The bright spot is that we expect asset quality will continue to remain strong.

CONCLUSION

It's hard to believe 2024 is behind us. As one community banker advised us recently when we were discussing this topic, "That simply means we start over in a day or two." This includes hitting the ground running as fast as possible. We agree with that and wish all of you a wonderful New Year.

Stay safe. See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

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Upcoming Webinars and In-Person Presentations

- February 25, 2025 – Graduate School of Banking-Madison, Wisconsin – Online Seminar, "Strategic Planning in Uncertain Times" (Greyson Tuck, presenter) Registration: Strategic Planning in Uncertain Times

- March 4, 2025 – Graduate School of Banking-Madison, Wisconsin – Online Seminar, "Strategies and Planning for Closely Held and Family Banks" (Philip Smith, presenter) Registration: Closely Held and Family Banks

- March 11-14, 2025 – Independent Community Bankers of America - ICBA LIVE 2025 Convention, Gaylord Opryland Resort and Convention Center, Nashville, Tennessee. "*The Almost Famous Ultimate Community Bank Q&A*" (Jeff Gerrish and Philip Smith, presenters) Registration: ICBA LIVE 2025 Convention

- March 11-14, 2025 – Independent Community Bankers of America - ICBA LIVE 2025 Convention, Gaylord Opryland Resort and Convention Center, Nashville, Tennessee. "*Gerrish's Musings LIVE*" (Jeff Gerrish and Greyson Tuck, presenters) Registration: ICBA LIVE 2025 Convention

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